Financial Instruments

Session 12
Employee Stock Options

- What is the contentious issue?
  - How to account for stock-based compensation
  - Options usually not immediately exercisable
    » Certain vesting rights exist
    » Impact on “quality of earnings”
  - If stock options issued for external services, options valued at FMV of services
  - If stock options issued for employment, FMV of options used
    » Why the difference?
Compensation cost based on intrinsic value on the date the option is granted

- Intrinsic value = Market price of stock (S) - exercise price (X)

» Not equal to fair market price of option

» If X ≥ S
  • No compensation cost recorded
  • Subsequent increases in S over X are not recognized for accounting purposes

- Game played: Make sure X ≥ S at award date.
Option Profiles

Some Terms
- In-the-money
- Out-of-the-money
- Intrinsic value
- Time value

<table>
<thead>
<tr>
<th>As _____ increase</th>
<th>Option Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset price</td>
<td>↑</td>
</tr>
<tr>
<td>Exercise price</td>
<td>↓</td>
</tr>
<tr>
<td>Maturity</td>
<td>↑</td>
</tr>
<tr>
<td>Volatility</td>
<td>↑</td>
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<tr>
<td>Interest rate</td>
<td>↑</td>
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</tbody>
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Call option

Put option
Resolution

- FASB: “Companies are encouraged but not required to charge the fair value of employee stock-based compensation against earnings”

- Choice:
  - **Use SFAS 123**
    » An option model approach
  - **Continue to use APB 25**
    » Must disclose in footnotes the impact on NI and EPS.
Derivatives - Briefly

- FASB provided guidance on accounting for:
  - Foreign exchange forward contracts
  - Currency futures
  - Currency swaps

- No guidance for:
  - Interest rate forwards
  - Nearly all options
  - Interest rate swaps.
Accounting Issue

- Primary issue is the timing of recognition of gains and losses on the hedge and the underlying assets or liabilities.
- Realized and unrealized gains / losses are recognized in current income:
  - For hedging instruments that do not meet hedge criteria.
  - When hedged items are carried at market value.
The End